Office of Chief Counsel
Internal Revenue Service
memorandum

date: December 2, 2002

to: [redacted]
LMSB Team Coordinator
Group [redacted] (Natural Resources)
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from: Roy Wulf
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subject: [redacted] ([redacted] & [redacted])
Disposition of Installment Obligations [modified version]
Case #: POSTF-160383-01

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ISSUES

1. Pledges of installment notes are generally treated as dispositions of the notes, and trigger gain recognition. However, this rule does not apply to farm property. Are timber, timberlands and logging roads farm property?

2. Should the pledge of the installment notes be characterized for tax purposes as a disposition of the installment notes under section 453B?

CONCLUSIONS

1. Timber, timberlands and logging roads are farm property. Therefore, the restrictions on installment sales contained in sections 453 (dealer dispositions) and 453A (interest on deferral and the "pledge rule") do not apply to this case.

2. In substance, the pledge of the notes was not a disposition. The taxpayer has retained sufficient benefits and burdens of ownership of the notes to sustain its characterization of the transaction as a true pledge.

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FACTS

[redacted].

[redacted]

[redacted].

Series	Due Date	Interest Rate	[redacted] Face Amount	Investor Note Face Amount
[redacted]	[redacted]	[redacted]%	$[redacted]	$[redacted]
[redacted]	[redacted]	[redacted]%	$[redacted]	$[redacted]
[redacted]	[redacted]	[redacted]%	$[redacted]	$[redacted]
[redacted]	[redacted]	[redacted]%	$[redacted]	$[redacted]
[redacted]	[redacted]	[redacted]%	$[redacted]	$[redacted]

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[1] At the same time, various [redacted] entities sold other assets to [redacted]. For purposes of this memorandum, it is assumed that the allocations of the purchase prices contained in the agreements should be respected.

[redacted]	[redacted]	[redacted]%	$[redacted]	$[redacted]
		%	$	$
		%	$	$
	TOTAL		$[redacted]	$[redacted]

For each of the [redacted] Series, the Investor Note was for an amount equal to [redacted]% of the [redacted], while the maturities and interest rates were identical.

The [redacted] were used as collateral for the Investor Notes. [redacted] provided a limited guaranty on the Investor Notes; if [redacted] defaults on the notes, [redacted] will be liable to pay [redacted]% of the principal amount of the Investor Notes outstanding. [redacted].

[redacted].

[redacted] claims that the $[redacted] of cash is not taxable, and that it can continue to defer the gain from the sale of the timber until the [redacted] are paid.

ANALYSIS

A. Introduction and Summary

Under the installment sale method, a taxpayer defers taxation on its gain until the proceeds from the sale are received. When a taxpayer receives the proceeds of an installment sale by either selling or otherwise disposing of the installment obligation, it is generally required to pay the related tax.

When installment notes are pledged as security for loans, the loan proceeds may be treated as proceeds from disposition.

This argument requires a "facts and circumstances" analysis, where the Service usually attempts to prove that in substance the pledge was actually a sale. The Service generally did not succeed.

Congress closed this loophole for most taxpayers by enacting the "pledge rule" of section 453A. However, farm property is expressly excepted from the pledge rule. Timber, timberland and logging roads are farm property, so the pledge rule will not apply in this case.

Congress also narrowed the availability of the deferral by providing that dealer dispositions are not eligible for the installment method. However, dispositions of farm property *cannot be dealer dispositions, so the sale was not a dealer* disposition.

Therefore, the resolution of this case turns on whether, in substance, the "pledge" was actually a disposition of the [redacted]. A "facts and circumstances" analysis is necessary, and while reasonable people may differ, we conclude that [redacted] and subsidiaries retained sufficient risks and rewards of ownership in the [redacted] so the "pledge" will not be treated as a disposition.

B. Section 453

Section 453 provides the general rules for accounting for installment sales. "Dealer dispositions" are not eligible for this treatment. I.R.C. §453(b)(2)(A). The term "dealer disposition" does not include "the disposition on the installment plan of any property used or produced in the trade or business of farming (within the meaning of section 2032A(e)(4) or (5)." I.R.C. §453(l)(2)(A).

The term "trade or business of farming" is not defined in section 2032A(e)(4) or (5). However, it is clear that forestry is treated as farming. Sherrod v. Commissioner, 82 T.C. 523 (1984), Estate of Holmes v. Commissioner, T.C. Memo 1991-477, aff'd sub nom Poisl v. Commissioner, 978 F.2d 1261 (7th Cir. 1992) (unpublished opinion).

The word "farm" is defined in section 2032A(e)(4) as including woodlands, while the term "qualified woodlands" is defined as identifiable real property used in (i) the planting, cultivating, caring for, or cutting of trees, or (ii) the preparation (other than milling) of trees for market. I.R.C. §2032A(e)(13). The phrase "farming purposes" is likewise defined as including (i) the planting, cultivating, caring for, or cutting of trees, or (ii) the preparation (other than milling) of trees for market. I.R.C. §2032A(e)(5).

Section 2032A concerns valuation of real property for estate tax purposes, and the benefits are limited to small farms. However, the size limitations are contained in section 2032A(a). Section 453 does not reference the entire code section, but specifically references "section 2032A(e)(4) or (5)," so the size limitations do not have any bearing on the definition for installment sale purposes. I.R.C. §453(l)(2)(A).

The timber, timberlands and logging roads were "used or produced in the trade or business of farming" so the sale of the property was not a dealer disposition. Section 453 does not prohibit [redacted] from applying the installment method.

C. Section 453A

The "pledge rule" provides that where installment obligations are pledged as security for a loan, the net proceeds of the loan are treated as payments received on the sale of the installment obligations. I.R.C. § 453A(d). However, section 453A and the "pledge rule" do not apply to installment obligations arising from the disposition "of any property used or produced in the trade or business of farming (within the meaning of section 2032A(e)(4) or (5))." I.R.C. § 453A(b)(3)(B).

As explained above, section 2032A is an estate tax provision intended to benefit small farms, but the definition should be applied based on the literal language of the cross referenced sections (sections 2032A(e)(4) and (5)). It is clear that the timberlands and logging roads were "used or produced in the trade or business of farming," so section 453A does not apply to these transactions. Section 453A does not require [redacted] to recognize income upon receiving the proceeds of the Investor Notes (and also does not require [redacted] to pay an interest charge on the deferred tax, as provided in section 453A(a)(1)).

D. Section 453B(a)

Section 453B(a) provides the following general rule:

> "If an installment obligation is satisfied at other than its face value, or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result ...."

The question here is whether the [redacted] were "sold, or otherwise disposed of". No regulations or cases interpret section 453B(a), but the pertinent wording is identical to the wording of former section 453(d)(1), which was the subject of considerable litigation.[2] We conclude that [redacted] did not dispose of the [redacted].

In general, federal income tax consequences are governed by the substance of a transaction determined by the intentions of the parties to the transaction, the underlying economics, and all other relevant facts and circumstances. Gregory v. Helvering, 293 U.S. 465 (1935), XIV-1 C.B. 193. The label the parties affix to a transaction does not determine its character. Helvering v. Lazarus & Co., 308 U.S. 252, 255 (1939), 1939-2 C.B. 208; Mapco Inc. v. U.S., 556 F.2d 1107, 1110 (Ct. Cl. 1977). A transaction is a sale if the benefits and burdens of ownership have passed to the purported purchaser. Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981).

The assignment of an installment obligation as collateral security for a loan may be a "disposition" of the obligation under former section 453(d). Rev. Rul. 65-185, 1965-2 C.B. 153. In United Surgical Steel Co., Inc. v. Commissioner, 54 T.C. 1215, 1229-30, 1231 (1970), acq., 1971-2 C.B. 3, the taxpayer assigned installment obligations that arose from the sales of cookware on the installment basis to a bank as collateral for a loan. The court rejected the Service's argument that the assignment should be treated as a disposition, and identified the following factors as relevant:

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[2] Under the re-enactment doctrine, the use of identical statutory language, without legislative history to the contrary, means that the accepted interpretation of that language is valid. See Provost v. U.S., 269 U.S. 443 (1926).

(1) the form of the transaction was a loan, and not a sale;
(2) the customers were not notified of the transfer of the notes;
(3) the taxpayer serviced the notes;
(4) payments to the bank did not correspond to collections on the notes;
(5) the bank imposed restrictions on the operations of the taxpayer that were inconsistent with anything other than a lender-borrower relationship; and
(6) only the taxpayer had the potential for gain from collection of the notes; the bank could only earn interest.

See also Town & Country Food Co., Inc. v. Commissioner, 51 T.C. 1049, 1057 (1969), acq., 1969-2 C.B. xxv (applying factors (3), (4),and (8) in determining that an assignment was not a disposition).

In addition to the factors listed above, courts have considered the following factors to be relevant in determining whether the benefits and burdens of ownership of debt instruments have passed:

(1) which party had the power of disposition, American Nat'l Bank of Austin v. U.S., 421 F.2d 442, 452 (5th Cir. 1970), cert. denied, 400 U.S. 819 (1970);

(2) which party bore the credit risk, Union Planters Nat'l Bank of Memphis v. U.S., 426 F.2d 115, 118 (6th Cir. 1970), cert. denied, 400 U.S. 827 (1970); Elmer v. Commissioner, 65 F.2d 568, 569 (2d Cir. 1933), aff'g 22 B.T.A. 224 (1931).

See also Rev. Rul. 82-144, 1982-2 C.B. 34.

The Service lost most of the cases where it argued that purported pledges were actually dispositions of installment notes. The facts in those cases were more favorable for the taxpayers than the facts in this case. In each case, the court analyzed the facts and circumstances, generally focusing on whether there had been a significant shift in the incidence of ownership of the installment obligation. See Town & Country Food Co. v. Commissioner, 51 T.C. 1049 (1969), acq. 1969-2 C.B. xxv; United Surgical Steel Co., Inc. v. Commissioner, 54 T.C. 1215 (1970), acq. 1971-2 C.B. 3(taxpayer entitled to draw on a line of credit not to exceed 88% of pledged notes, and continued to collect payments on the notes); Yancey Bros. Co. v. United

States, 319 F. Supp. 441 (N.D. GA. 1970) (taxpayer paid property taxes on pledged notes, continued to collect the payments on the notes, and was entitled to borrow additional sums if the collateral exceeded 105% of the loans); Prescott v. U.S., 64-2 U.S.T.C. ¶ 9879 (D.C. Or. 1964).

In Schaeffer v. Commissioner, T.C. Memo. 1981-27, the court again ruled against the Service on the issue. The court held that an assignment to a bank of an installment obligation, payable by a corporation, as collateral security for a loan was not a sale or other disposition despite the fact that --
(i) the transactions were conducted on the same day,
(ii) the loan amount was equal to the installment obligation,
(iii) the taxpayer eventually had the note payments made directly to the bank to satisfy his debt.

The Court primarily relied on the following facts -
(i) the interest rates and maturity dates of the obligations differed,
(ii) the transaction was structured as a loan,
(iii) the petitioner paid state income tax on the interest received under the installment obligation, and
(iv) in the Tax Court's prior three reported opinions on the issue the substance was as the parties had cast it.

The taxpayer and his brother were partners. In earlier litigation concerning the brother's identical interest in the same transaction, another court held that the transaction was a sale. Bogatin v. U.S., 78-2 U.S.T.C. ¶ 9733 (W.D. Tenn. 1978). The Tax Court declined to follow that opinion, illustrating the subjective nature of the facts and circumstances analysis.

The Tax Court ruled in favor of the Service on this issue in Branham v. Commissioner, 51 T.C. 175 (1968) and Mather v. Commissioner, 57 T.C. 666 (1972). In Branham, the taxpayer assigned note payments exactly equal to the payments due on the same days as his own loans. The court stated "we conclude that the petitioner did not in substance pledge the . . . installments." In Mather, there was no real evidence that the obligations were pledged, even in form; the court followed the documents and found that there was a sale.

E. Application of Section 453B(a)

No one factor is dispositive of the issue of whether a sale has taken place. The facts and circumstances determine the importance of each factor. Thus, a factor-by-factor analysis is necessary to determine whether [redacted] sold the [redacted].

(1) Were the transfers treated as sales?

The form of the agreement between [redacted] and the Investors is that of a pledge agreement and not a sales contract. This factor favors the taxpayer.

(2) Was [redacted] notified of the transfer of the [redacted] to the Investors?

The [redacted] provide that the notes would be pledged as security for third party financing. [redacted] agreed to provide financial information to the Investors and the [redacted] sale term sheet refers to the Collateral Agency Agreement. See, e.g., United Surgical Steel Co., 54 T.C. at 1229-30, 1231 (customers' lack of notice of assignment was a factor supporting financing treatment).

However, notification that the [redacted] would be used as collateral for the Investor Notes is not inconsistent with a pledge of the [redacted]. Similarly, if the notes were transferred to [redacted] to be held as collateral for the Investor Notes, [redacted] may have held the collateral on behalf of [redacted] and the Investors.

(3) Which party handles collections and services the [redacted]?

Neither party handles collections of payments or services the [redacted]; [redacted] assumed these tasks. We do not know how [redacted] was compensated and we do not know how the Restricted Deposit Account functions. Compare United Surgical Steel Co., 54 T.C. at 1229-30, 1231, and Town & Country Food Co., 51 T.C. at 1057 (taxpayers collected payments and serviced installment notes) with Elmer, 65 F.2d at 570 (taxpayer did not collect payments on installment notes).

Interest payments to Investors are due one month after payment to [redacted]. If [redacted] acted as [redacted]'s agent for collection, [redacted]'s payments to [redacted] would be consistent with [redacted]'s ownership of the [redacted]. [redacted] was entitled to investment gains during the one month lag period between payment to [redacted] and payment to the Investors.

(4) Did payments to the Investors correspond to collections on the [redacted]?

The interest payments to Investors are due 30 days after payments on the [redacted]. The payments on the [redacted] are somewhat larger than the payments on the Investor Notes since the Investor Notes were issued for [redacted]% of the face amount of the [redacted]. The fact that payments on the [redacted] would be used to make payments on the Investor Notes is not necessarily inconsistent with a loan. The Collateral Agency and Payment Agency Agreement uses a number of undefined terms so the arrangement is not clear.

The payments to the Investors generally track the [redacted] payments. However, while the interest rates are identical there is a [redacted]% difference in amounts and a 30-day difference in due dates. See Branham v. Commissioner, 51 T.C. 175, 180 (1968) (pledge treated as disposition where taxpayer's payments to purported lender were exactly the same in amount and timing as payments on underlying installment notes). Compare to cases the Service lost, such as United Surgical Steel Co., 54 T.C. at 1230, and Town & Country Food Co., 51 T.C. at 1057 (lenders looked to taxpayers for repayment, not to payments on pledged installment notes); United Surgical Steel Co., 54 T.C. at 1231 (taxpayer did not borrow maximum amount allowable under agreement); and Yancey Bros. Co., 319 F. Supp. at 446 (taxpayer had access to additional funds without providing additional collateral).

(5) Did the Investors impose restrictions on the operations of [redacted] that are consistent with a lender-borrower relationship?

This factor is neutral. The Investors imposed only minor restrictions on [redacted] and [redacted] as guarantor. See sections [redacted] of the Investor Notes. The Investors do not require [redacted] or [redacted] to maintain a specified ratio of assets to liabilities or current assets to current liabilities. The Investors do not have the right to review [redacted] or [redacted]'s books and records.

However, the Investor Notes were, in essence, limited recourse (guarantee of [redacted]% of outstanding principal amount of Investor Notes by [redacted] in event of default on [redacted]) obligations collateralized by the [redacted]. In circumstances involving limited recourse or nonrecourse notes, restrictions on the operations of the borrower would generally not affect a lender's collection risk.

(6) Which party had the power to dispose of the [redacted]?

This factor is generally neutral. The Investors cannot dispose of the [redacted], and [redacted] cannot dispose of the [redacted] unless it prepays the Investor Notes. The Investor Notes contain significant prepayment penalties. If the Investors were lenders, then it would be reasonable to expect [redacted] to have the ability to substitute collateral of equal value to secure the outstanding loan. Cf. American Nat'l Bank of Austin, 421 F.2d at 452 (purported seller could dispose of the securities without prior approval from purported buyer). [redacted] did not have this ability. On the other hand, many loan agreements lack a provision for substitution of collateral.

(7) Which party bears the credit risk on the [redacted]?

Both parties bear some credit risk. Although [redacted] eliminated [redacted]% of its exposure to credit risk on the [redacted], it retains some risk because it is entitled to any excess of the amount collected from [redacted] over the amount due to the Investors. [redacted] as guarantor, also has some risk.

(8) Which party has the potential for gain on the [redacted]?

The Investors's risk of loss on the [redacted] was substantial because they advanced [redacted] percent of the face amount of each [redacted], and were protected from loss only by a limited guaranty. If interest rates decline, the value of Investor Notes and the [redacted] will increase, while if interest rates increase, the value of the notes will decrease. The Investors have [redacted]% of this interest rate risk and reward. The Investors also bear [redacted]% of the risk of loss if the [redacted] lose value (because [redacted] cannot pay or becomes a greater credit risk).

After pledging the [redacted], [redacted] had little potential to realize gain on the [redacted]. Only after the Investors recoup the principal will [redacted] receive any distribution payments. [redacted]'s small potential benefit if [redacted] does not default does not in itself make [redacted] the owner of the [redacted]. <u>See</u> Rev. Rul. 83-51, 1983-1 C.B. 48.

F. Summary

This matter is a closer call than taxpayer victories such as <u>United Surgical Steel Co.</u>, <u>Town & Country Food Co.</u> or <u>Yancey Bros. Co.</u> In those case, the pledged installment notes were substantially different from the notes issued by the taxpayer. The <u>Prescott</u> opinion did not contain any discussion of the facts, except that the trial judge had concluded that in substance there was no disposition.

<u>Schaeffer</u> is probably the case most similar to this matter. As in <u>Schaeffer</u>, the transactions were conducted on the same day and the transaction was structured as a loan. In <u>Schaeffer</u>, the loan amount and installment obligation were for the same amount, while in this case the loan amount was not quite equal to the installment obligation. While in <u>Schaeffer</u>, the installment note payments were eventually made directly to the lenders, in this case [redacted] acts as an intermediary. In <u>Schaeffer</u>, the interest rates and maturity dates of the obligations differed, while they are identical here. We do not know if [redacted] paid local taxes on the installment obligation. On the whole, <u>Schaeffer</u> seems to indicate that the Tax Court may be unwilling to recharacterize pledges as dispositions.

If the [redacted] and the Investors Notes had been for the same amounts, the argument for a disposition would be stronger. Furthermore, the limited guaranty provided by [redacted] strengthens the taxpayer's argument that the transaction is a true pledge. While guarantees generally have very limited tax consequences, the guaranty is part of the substance of the transaction.

It is difficult to assess the effect of the section 453A "pledge rule" on the section 453B argument. The rule was enacted as part of the 1987 Act, and replaced the "proportionate disallowance" rule of the Tax Reform Act of 1986. On the one hand, section 453A does not refer to section 453B or the disposition provision, leading to the conclusion that the enactment of the pledge rule has no effect on the disposition argument. On the other hand, a court could conclude that Congress intended to exempt farm property, and that the section 453B argument is a back way into applying the pledge rule to farms.

On balance, we conclude that the transaction is not a disposition, and that the pledge cannot be characterized as a sale of the installment notes.

Please call me if you have any questions regarding this memorandum.

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